

WEEKLY ECONOMIC COMMENTARY -- WEEK OF JANUARY 19, 2007

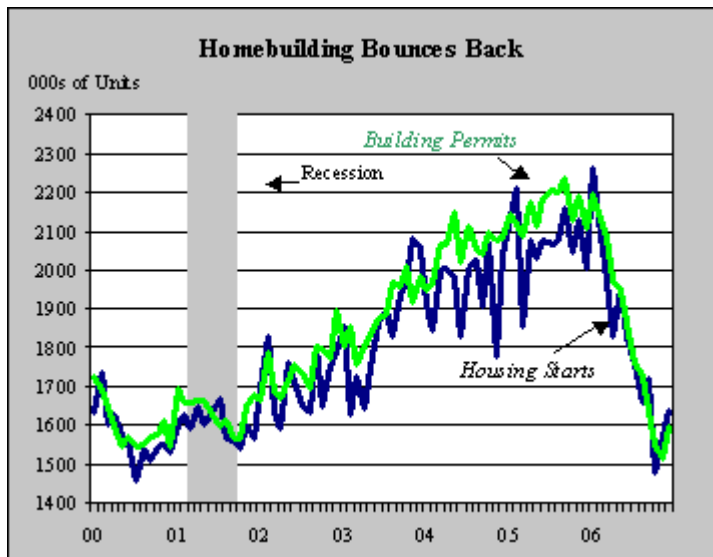
First the numbers, then the story

FINANCIAL INDICATORS				
INTEREST RATES	January 19	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.13%	5.08%	4.98%	4.35%
6-month Treasury bill	5.16	5.14	5.07	4.46
3-month LIBOR	5.36	5.36	5.36	4.58
2-year Treasury note	4.92	4.88	4.72	4.35
5-year Treasury note	4.78	4.76	4.59	4.29
10-year Treasury note	4.78	4.77	4.62	4.35
30-year Treasury bond	4.86	4.86	4.76	4.52
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	3.77	3.72	3.64	3.44
10-Year	3.99	3.94	3.87	3.87
30-Year	4.49	4.44	4.33	4.45
30-year fixed mortgage rate				
	6.23	6.21	6.13	6.10
15-year fixed mortgage rate				
	5.98	5.96	5.89	5.67
1-year adjustable rate				
	5.51	5.44	5.44	5.18
STOCK MARKET				
Dow Jones Industrials	12565.53	12556.08	12343.22	10667.39
S&P 500	1430.50	1430.73	1410.76	1261.49
NASDAQ	2451.31	2502.82	2401.18	2247.70
Commodities				
Gold (\$)- 100 Oz	636.40	627.10	623.50	554.00
Oil (\$ per barrel) - Crude Futures (NYMEX)	51.87	52.85	62.35	68.48
KEY ECONOMIC INDICATORS				
INDICATOR (Latest Month/Quarter)	Current Month/Qtr	Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Industrial Production (Dec) - % change	0.4	-0.1	-0.1	0.1
Capacity Utilization (Dec) - Percent	81.8	81.6	81.8	82.0
Housing Starts (Dec) - 000s of units	1642	1572	1478	1640
Producer Price Index (Dec) - % change	0.9	2.0	-1.6	0.0
Consumer Price Index (Dec) - % change	0.5	0.0	-0.5	0.0
Core CPI (Dec) - % change	0.2	0.0	0.1	0.2

It's hard to believe that just a few short months ago the financial markets, particularly the bond sector, thought the expansion was on the verge of expiring, requiring the Federal Reserve to cut interest rates to resuscitate growth no later than the March 2007 policy meeting. After all, following a robust 5.6 percent increase in the first quarter, real GDP downshifted to a growth rate of 2.6 percent in the second quarter and to 2.0 percent in the third. As the fourth quarter began, the consensus among economists was that the economy would limp into the new year at an even slower pace. What's more, with the housing correction taking an ever-larger bite out of construction spending and household wealth, prospects for the first quarter seemed even bleaker.

But that was then. In as dramatic turnabout as could be imagined, the outlook has suddenly taken wings of flight. Instead of limping into the new year on gimpy legs, the economy appears to have ingested a Popeye-sized dose of life-affirming spinach, pumping up its growth engine. While the first snapshot of the fourth quarter won't be available until January 31, enough is at hand to give a pretty good sense of how the economy performed during the period. One thing is clear: the housing correction continued to

be a major drag, most likely shaving more than 1 percentage point from the fourth-quarter's growth rate. What's more, given the lag between residential spending and housing starts, which fell sharply last year, the first quarter will also suffer a growth haircut of equal magnitude due to the housing downturn. That general prognosis remains intact, despite the surprising rebound in starts in December, which may be mostly weather-related.



But contrary to widespread expectations, the housing slump has thus far not spread to other sectors of the economy. In particular, the chief presumed victims, households, have blithely ignored the erosion in wealth associated with sinking home values and continued to spend at a muscular pace. That was amply documented in last week's retail sales report, which revealed another strong gain in December following a greater-than-expected increase in November. Since consumers account for 70 percent of GDP, their late-year surge in spending probably lifted the fourth-quarter's growth rate to 3 percent or so, depending on how much of the increase came at the expense of inventories. If inventories were drawn down to accommodate the increase in demand, growth will come in lower, but it would set the stage for a production rebound in the first quarter. Indeed, economists are already raising their sights for the current quarter, with a consensus forming around 2 ½- 3 percent growth rate.

Although a 2 ½-3 percent rate is a fraction below the economy's noninflationary speed limit, it is hardly a pace that requires a Fed rate cut to resuscitate growth. Not surprisingly, the financial markets are no longer aggressively pricing in such a move, which at one point late last year was thought possible as early as the January 31 policy meeting. Now the prospect of a rate cut in March, the consensus view as recently as a month ago, has also been pushed back. Indeed, more than a handful of pundits are now warning that the Fed is just as likely to raise rates over the second half of the year as cut them. The Fed itself is doing little to discourage that notion, as public statements by numerous officials continue to hammer home the point that inflation remains more of a risk than recession. San Francisco Fed Governor Janet Yellen on Wednesday gave considerable attention to the fact that the labor market is going "gangbusters" despite the mid-year growth slowdown, raising the question of whether the government's GDP data may have overstated the extent of the slowdown. She noted that the income side of the ledger is growing faster than the output side, a discrepancy suggesting hidden strength in the economy that is not being fully captured in the GDP data.

Another putdown of recession fears was sounded by Richmond Fed Governor Jeffrey Lacker on Thursday. In a speech entitled "Economic Outlook", he gave more than lip service to the housing threat, noting that we can't be sure that the housing market has stabilized despite some positive numbers in

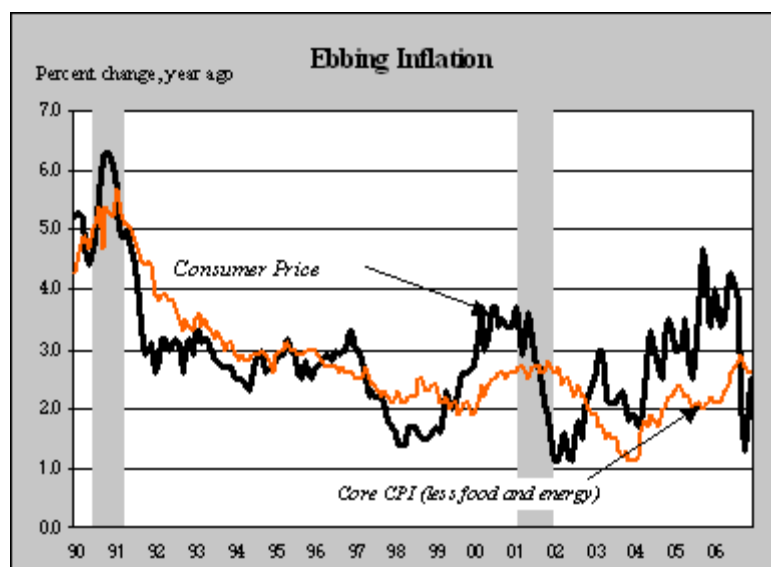
recent months. Nonetheless, he adamantly asserted that ... " the risk that core inflation surges again, or does not subside as desired, clearly remains the predominant macroeconomic policy risk."

Regarding the recent slowdown in economic activity, Lacker drew an analogy between the present performance of the economy and the performance of the economy in the mid-1990's. He said the current slowdown in the economy resembles the subpar performance in real GDP in early 1995. "Since growth clearly has slowed, the question on many people's minds is, 'What's next?'," said Lacker. "For some guidance, we can look back to similar episodes in the past."

"The long expansions of the 1980s and the 1990s resemble our current expansion in several key respects. Both were unusually long, by historical standards. Both saw substantial increases in production, employment and wealth. And in both cycles, there was a somewhat bumpy transition between an early, high-growth phase and a period of several years of more average, trend-like growth. For example, the cyclical expansion of the 1990s was the longest in our nation's history, and yet in the midst of this period of strong, sustained growth, there was a two-quarter period in early 1995 in which real GDP increased by only 0.9 percent at an annual rate, driven in part by weakness in housing investment. That barely perceptible growth was followed by an additional three quarters of growth at a subpar rate, but then real GDP accelerated and grew quite rapidly for the next four years. This example suggests that we should not be discouraged this time around by an uneven transition from rapid to more sustainable growth," said Lacker.

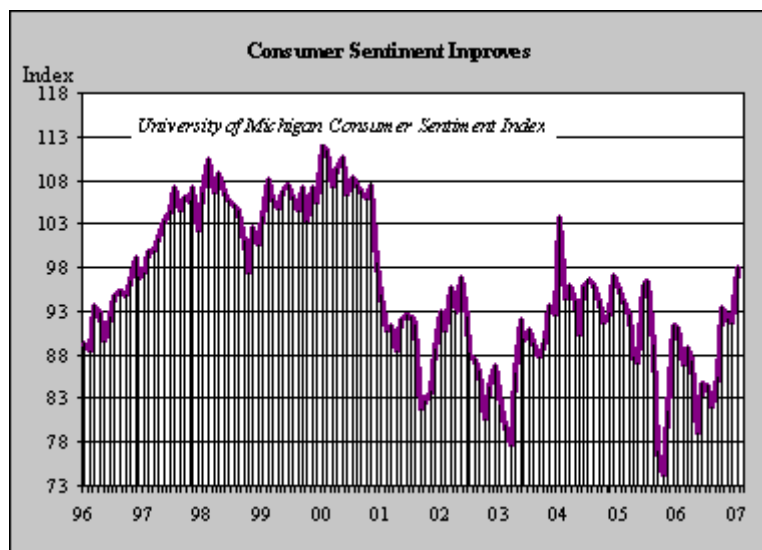
Interestingly, Lacker didn't cite the Fed's actions during that period -- but we will. Although the Federal Reserve raised rates on February 1, 1995 (+50 bps to 6.00%), several months later, the Fed had to reverse direction and cut rates on two occasions in 1995: July 6, 1995 (-25 bps to 5.75%) and December 19, 1995 (-25 bps to 5.00%). Clearly, the policymakers are displaying considerably more patience this time, allowing the underlying crosscurrents to run their course before pulling the trigger. If the growth rebound in the fourth quarter and the prospect of continuing strength in the current quarter truly marks the end of the slowdown, the Fed's decision to stand pat may well be applauded when all is said and done.

No doubt, the Fed has to be influenced by the spate of data in recent weeks, the vast majority of which have come in above expectations. By the same token, the economy's stronger performance does not seem to have intensified inflationary pressures, which continue to be the Fed's primary concern. True, the consumer price index jumped by a greater-than-expected 0.5 percent in December, the largest since last April. But the surge was primarily due to a 3.7 percent spike in energy prices, which have since unwound as the plunge in crude oil prices in January is filtering through to the retail level. Even with the sporadic increases last year, energy prices increased much more slowly in 2006 than in 2005 and 2004. As a result, the overall consumer price index also slowed considerably, rising by 2.5 percent last year versus 3.4 percent and 3.3 percent in the previous two years, respectively.



What matters most to the Fed is the trend in the core CPI, which excludes the volatile energy and food prices and increased by an as-expected 0.2 percent in December. Just as the housing slump has had only a limited impact on the rest of the economy, the pass-through effect of the oil-price surges on other goods and services in recent years has also been muted. Yes, the core CPI accelerated in 2006, rising by 2.6 percent compared to 2.2 percent in both 2004 and 2005, and up from the near-historic low of 1.1 percent in 2003. But the peak for the cycle appears to have been reached last September, when the rate hit 2.9 percent. Over the past three months, the core CPI has increased by an annual rate of only 1.4 percent, clearly a trend that must be comforting to the Fed.

That said, the annual rate of increase in the core CPI is still above the Fed's comfort zone, which is generally perceived to be in the 1 ¼ % to 2 ¼% range. Two months ago, it was a foregone conclusion that the growth slowdown would persist over the foreseeable future, opening up enough slack in the labor and product markets to bring the inflation rate down to the Fed's preferred range. Now, the issue is not as clear-cut. The inflation concerns being voiced by Fed officials may well grow louder if the economy's resilience continues to prevail in coming months. Ultimately, consumers will decide the direction the economy takes, and recent signs indicate that households are not ready to zipper up their wallets and purses. According to the latest University of Michigan sentiment survey, just the opposite is the case. The preliminary reading for January shows that the sentiment index jumped to a three-year high.



To be sure, canvasses of consumer moods – such as those of Michigan as well as the Conference Board – are not reliable leading indicators of spending trends. Studies reveal that they are more a reflection of current and past developments than portents of spending developments. Nonetheless, households appear to be backing up their feelings with deeds, as manifested by their resilient shopping habits. Whether this resilience reflects positive fundamentals or is a temporary response to the slide in energy prices and the unusually warm weather in December and early January remains to be seen. Hence, the debate over whether the Fed will cut or raise rates will likely go unresolved for a while longer. We suspect that another alternative will soon gain adherents, namely that the policy makers will just do nothing over the course of the year.